REPLY BRIEF OF
FITCHBURG GAS AND ELECTRIC LIGHT COMPANY

D.T.E. 99-118

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I. INTRODUCTION

In his initial brief ("AG Br."), the Attorney General has directly departed from the stated positions of his expert witness. Compare AG Br. at 41 (recommending 9.9% ROE) with Exh. AG-1 at 8-9 (recommending 10.58 ROE). He has presented new arguments at the last minute that are not supported by the record. Compare AG Br. at 25-26 (advocating no change in depreciation rates) with AG Complaint at 4 (alleging FG&E's depreciation accrual rates too low); compare AG Br. 14 (seeking to remove investment for Princeton Paper) with AG Complaint (no reference), Exh. AG-3 (no reference). He has presented his case with the obvious intent to maximize the dollars he could claim to be overearned, and without substantial evidence to uphold his burden of proving that FG&E's rates are not just and reasonable.

The import of the Attorney General's abandonment on brief to the positions taken by his witness during the hearings and discovery phase cannot be overstated. As set forth below and in FG&E's initial brief ("FG&E Br."), the Attorney General bears the burden of proof on all issues in this G.L. c. 164, sec. 93 ("Sec. 93") proceeding. See e.g., Metropolitan Dist.Comm'n v. Dep't of Pub. Utils., 352 Mass. 18, 25 (1967)(party seeking rate change under Section 93 bears burden of proof). Where the Attorney General has turned his back on his witness, he stands before the Department with no affirmative evidence whatsoever. See Deacon Transportation, Inc. v. Dep't of Pub. Utils., 388 Mass 390, 394, 446 N.E.2d 698, 701 (1983)(petitioner has burden of producing affirmative evidence). Moreover, he has reduced the value and credibility of the substantive claims made by his expert. By picking and choosing those positions of Mr. Effron which he will support or reject, the Attorney General suggests that little evidentiary weight should be afforded to the opinions of his own witness.

The Department should reject the Attorney General's attempt to now establish his prima facie case on brief because it is inconsistent with his burden as the proponent of the rate change under investigation. Fundamental due process requires that a responding party be given notice of the claims of the movant and a fair opportunity to present responsive evidence and test the veracity and credibility of the moving party's assertions. See, Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950) By raising these arguments on brief, FG&E has been denied this due process. The Attorney General's new positions, announced only after hearings, must be rejected as untimely and contrary to his obligation to put forth his affirmative case well before the briefing stage of the proceeding. See Fitchburg Gas and Electric, DTE 98-51, pp. 9-10 (1998).

While the Attorney General acknowledges that he has the burden of proof in this case, he has failed to meet that burden by producing substantial evidence to prove new rates. See Fryer v. Dep't of Pub. Utils., 374 Mass. 685, 290, 373 N.E.2d 977, 981(1978) (rejecting proposed rate reduction for lack of substantial evidence to prove new rates). The Attorney General is misguided in assuming he can prove his case by merely attacking the testimony of FG&E's witnesses, or by claiming that FG&E has failed to produce countervailing evidence. See e.g., AG Br. at 30-31. While such tactics may be appropriate to oppose a regulated company's request for a rate increase under G.L. c. 164, sec. 94 ("Sec. 94"), they are inadequate to demonstrate affirmatively that a filed rate is unjust and unreasonable under Section 93. See Fryer v. Dep't of Pub. Utils., 374 Mass. 690, 373 N.E.2d at 981.

For example, the Attorney General presents no affirmative evidence to support his claims that there is load growth in the City of Fitchburg, that there should be no changes in FG&E's depreciation accrual rates, and that FG&E's return on equity should be set at 9.9%. See

AG Br. at 11-12, 25-26 and 40-41. As the proponent of the rate change, the Attorney General must produce substantial evidence to prove the new rates. Deacon Transportation v. Dep't of Pub. Utils., 388 Mass. 394, 466 N.E.2d at 701; Fryer v. Dep't of Pub. Utils., 374 Mass. 690, 373 N.E.2d at 981. The Attorney General can not *create* substantial evidence by either attacking the testimony of the opposing party or by pointing to the failure of the opposition to produce countervailing evidence. See Salisbury Water Supply Co. v. Dep't of Pub. Utils., 344 Mass 716, 720, 184 N.E.2d 44, 47 (1962)(nonacceptance of testimony does not create substantial evidence to the contrary); Deacon Transportation v. Dep't of Pub. Utils., 388 Mass. 394 (petitioner misperceived burden by relying on claims that opponent failed to produce countervailing evidence). As further discussed herein, because the Attorney General has failed to produce substantial evidence to demonstrate affirmatively his prima facie case on the core issue of what constitutes a fair and reasonable return on equity, the Department should grant FG&E's Motion to Dismiss the proceeding or adopt the return established by FG&E through substantial evidence. FGE Br. at 47-48.

The Department routinely places the burden of proving new rates with substantial evidence upon a utility seeking a rate increase under Sec. 94. This is appropriate because a petitioner controls the timing of its case, the scope of its request, and the substance of its prima facie presentation. FG&E submits that it would be improper for the Department to impose any lesser burden on the Attorney General under Sec. 93, when the law states that FG&E's filed rates are just and reasonable unless and until they are demonstrated to be otherwise.

With that, we turn to the specific issues raised in the Attorney General's brief.

II. STANDARD OF REVIEW

A. The Attorney General has neither Accepted, nor Met, the Burden of Proving his Section 93 Claim

In his brief, the Attorney General asserts that the statute is silent on the burden of proof and therefore, if he meets his prima facie burden, his responsibilities end. See AG Br. at 4, 5 (once he shows evidence on the "narrow issue" of over earning, his burden is satisfied). That recitation, however, does not accurately reflect the law as stated by the Supreme Judicial Court or the United States Supreme Court. It is well established that "where a reduction or other adjustment is sought in an existing rate (e.g. under [Sec. 93]) which has been approved for general application, the party seeking the benefit of such an adjustment has the burden of proving that the existing rate should be changed." Metropolitan Dist. Comm'n v. Dep't of Pub. Utils., 352 Mass. at 25, citing Louisville & Nashville R.R. v. United States, 238 U.S. 1, 11 (1915); Swift & Co. v. United States, 343 U.S. 373, 382 (1952).

> "Certainly as a practical matter a utility should not, in the absence of explicit legislative direction, be required to embark upon a full dress justification of its rate structure every time an individual customer files a complaint. . . . [I]n complaint proceedings the burden is upon the complainant to show that existing rates are unreasonable or discriminatory."

Metropolitan Dist. Comm'n v. Dep't of Pub. Utils., 352 Mass. at 25, quoting Antioch Milling Co. v. Pub. Serv. Co. of No. Ill., 4 Ill.2d 200, 209 (1954).

Just as utilities bear the complete burden of demonstrating each element of a requested rate increase, the Attorney General, as the complainant, bears the complete burden on all of the elements necessary to justify a rate decrease. Fryer v. Dep't of Pub. Utils., 374 Mass. 690, 373 N.E.2d at 981 (complaining party must establish substantial evidence to prove new rates). The Attorney General, as the moving party, may not rely upon challenges to the Company's testimony to create substantial evidence to the contrary. Salisbury Water Supply Co. v. Dep't of

Pub. Utils., 344 Mass 721, 184 N.E.2d at 47.. Nor can the Attorney General meet his burden on any element by merely claiming that FG&E has failed to provide countervailing evidence. Deacon Transportation, Inc. v. Dep't of Pub. Utils., 388 Mass. 394, 446 N.E.2d at 701; See e.g., Metropolitan District Comm'n v. Dep't of Pub. Utils., infra.

The Attorney General has not met his burden, nor even attempted to establish through expert testimony, an appropriate cost of equity to demonstrate his core claim of overearnings. Further, he has confused this proceeding and sidestepped due process by contradicting the record and departing from the recommendations and record acceptance of his witness. [1] Because the Attorney General has failed to present a timely and accurate prima facie case, supported by substantial evidence, the Department should find that he has failed to meet his burden of proving new rates.

III. ARGUMENT

A. The Department Should Consider the Most Recent Test Year Data which was Readily Available to the Attorney General

The Attorney General claims that the Department should ignore FG&E's evidence relating to 2000 Test Year information because the Department decided to base its investigation on FG&E's electric distribution rates for calendar year 1999. AG Br. at 7- 8. The Attorney General alleges that FG&E decided to "rely primarily" on 2000 Test Year information because Mr. Collin presented extensive prefiled testimony relative to it. AG Br. at 7. The Attorney General, again, is incorrect: FG&E presented equal amounts of substantial evidence related to *both* 1999 and 2000 Test Years with appropriate pro forma adjustments. See, Exh. FGE-2 and attachments. Mr. Collin's prefiled testimony uses the 2000 Test Year to describe the appropriate

[1] For example, Mr. Effron accepted FG&E's position on a revised depreciation expense in his modified testimony, but the Attorney General abandons the testimony of its witness on brief. Compare Tr. 1 (5/30/01) at 8 with AG Br. at 26. Similarly, the Attorney General proposes a new return on equity for the first time on brief. AG Br. at 41.

pro forma adjustments, each of which was also made to the 1999 Test Year. See, Exh. FGE-2 at 6. Therefore, as Mr. Collin stated explicitly, all the narrative related to the 2000 Test Year applies to the 1999 Test Year and its pro forma adjustments. See Tr. 1 (5/30/01) at 73-75. Each and every substantive schedule describing the 1999 Test Year rate base, revenues, operating expenses and capital structure is provided in Mr. Collin's testimony and every adjustment made thereto is explained through Mr. Collin's narrative and schedules. Exh. FGE-2, Sch. 1999 MHC-Supp.-A through Sch. 1999 MHC-Supp.-21.

FG&E believes the 2000 Test Year provides information most consistent with the Department's stated preference to review rates using the most recent available information.[2] FG&E provided this information in response to the Attorney General's Motion to Compel, *even though* it resulted in a less favorable result (it shows a slighter revenue deficiency, including all appropriate pro forma adjustments). The Attorney General's witness admits that FG&E provided, and he had available, complete data on FG&E's year 2000 cost of service. Tr. 1 (5/30/01) at 16-17. FG&E also provided substantial and sufficient information relative to a 1999 Test Year and all appropriate pro forma adjustments.

The Attorney General implies that there is a substantive difference between the 1999 Test Year, with appropriate pro forma adjustments, and the 2000 Test Year with appropriate pro forma adjustments. In FG&E's opinion, there is no difference. The use of either test year, as appropriately pro formed, demonstrates that FG&E's current rates are just and reasonable.

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[2] The Supreme Judicial Court has noted the Department's practice in using the most recent data, and has recognized the necessity of relying upon "proof as nearly, as reasonable possible down to the date of the final decision." See Boston Edison Co. v. Dep't of Pub. Utils., 375 Mass 1, 24, 375 N.E.2d 305, 321 (1978); New England Tel. and Tel. Co. v. Dep't of Pub. Utils., 371 Mass 67, 71, 354 N.E. 2d 860, 864 (1976).

B. Operating Revenues

1. The Department Should Adopt FG&E's Proposed Adjustment For Princeton Paper To Reflect The Extraordinary Loss Of Revenues Which Have Not Been Replaced

On brief, the Attorney General pressed his claim that the reduction in revenues as a result of the loss of operations at the Princeton Paper facility in the City of Fitchburg was not a known and measurable adjustment, as shown by FG&E. AG Br. at 11. As stated by the Attorney General, "the issue at hand is whether the Princeton Paper sales and revenue lost since the 1999 [T]est [Y]ear will be made up by other customers during the time that the rates established in this case are in effect." AG Br. at 11.

The Attorney General has presented no substantial evidence to support his position that the known and measurable loss of Princeton Paper is an inappropriate post-test year adjustment. As the petitioner, the Attorney General controlled the timing of his action and the resulting test year. Where there is a significant amount of measurable change to that test year data, the Attorney General must account for such change and take the test year as he finds it. Failing to do so, the Attorney General points once again to the Unitil Corporation Form 10-Q filing with the Securities and Exchange Commission that fully disclosed the loss of Princeton Paper and the anticipated (at that time) retooling of the facility under Newark America. AG Br. at 12. The substantial evidence is that this filing was made consistent with SEC requirements governing public disclosure to investors of material events. Tr. 1 (5/30/01) at 113-115.

The Attorney General persists in his wishful thinking, without evidentiary support, by claiming that the load of Newark America will suddenly match the extraordinary base distribution revenues of the now-defunct Princeton Paper, or if it does not, that other customers will match the breech. AG Br. at 12-13. However, there is substantial evidence on this record that while Newark America would be a large customer by FG&E standards, it would not match

the base distribution revenues lost by the Princeton Paper demise, and unless the Attorney General is privy to information not on this record nor known to FG&E, no other customer's base distribution revenues will either. Tr. 1 (5/30/01) at 113-115; Tr. 2 (6/01/01) at 305-307. Nor does FG&E have any actual operating or usage data to estimate the potential base revenue contribution of Newark America; it relies on the information provided by Newark America relative to its prospective operations. Id. Therefore, based on this information, Newark America's base distribution revenues are not expected to be anywhere as significant as Princeton Paper, and are not known and measurable at this time.

Moreover, to support his revenue adjustment for Princeton Paper, Mr. Effron utilized a per-kWh assessment to infer the lack of any financial impact due to the loss of Princeton Paper. AG Br. at 13. In FG&E's view, using a per-kWh assessment to measure the financial impact of the loss of Princeton Paper's load on FG&E's revenues is not appropriate. As Mr. Collin testified, the Princeton Paper special contract contained an extremely high fixed-contract minimum demand billing that is unaccounted for in Mr. Effron's calculation. Exh. FG&E-2 at 23-26. For instance, under the Energy Bank contract, over 99% of distribution base revenues were derived from the fixed contract minimum demand charge (a very small portion -- $24,000 per year -- is derived from the customer charge). Exh. AG-IR-3-4; Exh. AG-IR-3-5. Furthermore, under the Princeton Paper special contract, roughly 96% of distribution base revenues are derived from the fixed contract minimum demand charge. Exh. AG-IR-3-10. The Attorney General continues to downplay the known and measurable loss of revenue associated with Princeton Paper as well as the nature of the contractual arrangements to Princeton Paper that resulted in a substantial portion of the revenues generated being demand-based.

Even if the Department were to consider a kWh assessment as a measure of overall growth on the FG&E system, the numbers simply do not support the Attorney General's argument. For instance, from 1999 to 2000, FG&E's kWh sales declined 6.4%. Exh. AG-IR-3-41. In addition, Billing Demands (kVa) declined 11.4%. Id. Furthermore, Mr. Collin testified that, based on first quarter 2001 actual results, FG&E anticipates that kWh sales growth will most likely be negative in 2001 due to the slowing economy. Tr. 1 (5/30/01) at 117-123. Assuming this trend continues, FG&E would, over the 3-year period, experience "at best" no growth in kWh sales, but more likely a *decline* in kWh sales due to the slowing economy. Based on this evidence, as well as the Department's understanding of the present economic environment, the Department should accept FG&E's proposal to eliminate Princeton Paper's 1999 revenues as known and measurable.

2. The Attorney General's Proposed Adjustment For Test Year End Number of Customers is Calculated Incorrectly and Contrary to Department Ratemaking Precedent

The Attorney General argues that Mr. Effron appropriately made an adjustment to recognize incremental revenues that would be generated by the customers being served at the end of the 1999 Test Year. AG Br. at 9. He further argues that this adjustment is appropriate as a matter of consistency "with the determination of the cost of service and as a matter of reflecting the revenue that the present rates will produce prospectively." AG Br. at 10. He claims that FG&E did not claim this adjustment was inappropriate. Id.

In fact, this adjustment is inappropriate, as well as inconsistent with ratemaking precedent that should be used to guide the Department's decision. Exh. FG&E-2 at 22-23. Consistency with the Department's ratemaking precedent is essential to ensure the proper balance is maintained between the various revenue and cost components of the revenue requirements calculation that are performed in accordance with long-standing practices and ratemaking

procedures. See Boston Gas Co. v. Dep't. of Pub. Utils., 367 Mass. 92, 104 (1975) (parties have right to expect reasoned consistency).

Despite the description provided by the Attorney General on brief to this adjustment, Mr. Effron's calculation does not reflect the use of test year-end number of customers. He has computed a simple average of total distribution revenues (excluding Princeton Paper) actually experienced during the 1999 and 2000 calendar years, in essence a revenue averaging method, crossing over two separate test years. There is no Department precedent for this type of calculation. Nor has Mr. Effron shown any substantive support for his revenue averaging methodology. This adjustment has no place in this proceeding.

FG&E does not subscribe to the premise that the Department should stray from its stated preference to rely on known and measurable revenue and expense adjustments when such information is plainly available. See e.g. Essex County Gas Co., D.P.U. 87-59 (1987); Milford Water Co., D.P.U. 92-101 (1992), citing Bay State Gas Co., D.P.U. 1122 (1982); North Attleboro Gas Co., D.P.U. 86-86 (1986); Haverhill Gas Co., D.P.U. 1115 (1982). FG&E disputes the Attorney General's method of computing the number of customers from which an average revenue calculation is derived and believes that the Department should dismiss it because it is arbitrary and without foundation.

C. Rate Base

1. Removal of Facilities From Rate Base

The Attorney General, for the first time on brief, argues that capital investment related to service facilities at Princeton Paper should be removed from FG&E's rate base. AG Br. at 14. He argues that because FG&E has testified that Princeton Paper is no longer operating, these service facilities are not used and useful. AG Br. at 14. However, the Attorney General has ignored the substance of FG&E's evidence: The transformer and related service facilities are

used and useful in serving the current, smaller customer on the premises, Newark America. FG&E has also testified that Newark's operations will be on-going in the rate year, and therefore, the service facilities will continue to be used and useful in the service of FG&E's customers. Tr. 1 (5/30/01) at 248-249.

2. Cash Working Capital Allowance

The Attorney General clearly stated in his brief his agreement with the regulatory policy that FG&E should receive cash working capital to pay for its operation and maintenance expenses. AG Br. at 15. The Attorney General also recognizes that the Department has relied on the 45-day convention for the calculation of this rate base element. AG Br. at 15.
The only point on reply is that the Attorney General has criticized the 45-day convention but has offered no substantive evidence upon which the Department can rely to replace its precedential consistency with the selective adjustments that Mr. Effron proposes.

The 45-day convention recognizes that over the whole of operating costs incurred by a regulated company, some costs will have a net lag greater than 45 days, some less. Tr.1 (5/30/01) at 103. In the absence of a complete study of all operating costs, however, selective adjustments to reduce the net lag that where favorable to the Attorney General should not be arbitrarily accepted when they are in dispute and unsupported by record evidence. See e.g. AG Br. at 18 (reduce external transmission to 6.8 day net lag). The Attorney General, who *bears the burden on this issue*, has failed to conduct any substantive studies or analysis to support his position on this issue. Therefore, the 45-day convention should be employed for administrative fairness and regulatory consistency.

3. The Department Should Allocate FG&E's Accumulated Deferred Income Tax Balance Based Upon Gross Plant

The Attorney General states that "accumulated deferred income taxes represent the difference between the net book basis of plant and the net tax basis of plant times the tax rate."

AG Br. at 19. Because the Attorney General's stated calculation uses three factors (net book basis, net tax basis and the current tax rate) to allocate deferred income taxes, Mr. Effron apparently believes it is necessary to choose one of the factors to allocate deferred income taxes, i. e. the net book basis. However, if this is the applied logic, one might also reasonably conclude that either of the other factors is just as appropriate for use as an allocation factor. FG&E disagrees.

In order to allocate the deferred tax reserve related to plant assets, one must understand why this reserve exists. Such deferred taxes arise primarily because of the timing differences between the book depreciation as calculated on *gross* plant and the tax depreciation calculated on *gross* plant balances. There is, therefore, a direct correlation between the basis of the calculation and gross plant; there is no correlation to net plant as asserted by the Attorney General. Furthermore, Mr. Effron fails to appreciate that net plant consists of the original gross plant cost reduced by accumulated depreciation. It is primarily the difference between the book accounting and the tax accounting periods of recovery of the original gross plant cost that results in accumulated deferred income taxes. Therefore, even though Mr. Collin agreed that Mr. Effron's proposed allocation method was not unreasonable, the net plant method is clearly result-oriented by Mr. Effron. It is intrinsically no more reasonable than the gross plant method, and in FG&E's view, less reasonable.

Contrary to the Attorney General's assertion, as FG&E explained in its testimony in this proceeding, the Federal Energy Regulatory Commission approved FG&E's Internal Transmission rates (FERC Docket No. ER00-1215-000 (Feb. 28, 2000)) using a gross plant allocator as the basis of allocating the deferred tax reserve to the internal transmission function. Compare AG Br. at 20 (allegation of no support) with Exh. FG&E-2 at 39; Tr. 1 (5/30/01) at 96-

97; concur New England Power Pool, 88 FERC 61, 140 (1999) (uses gross plant allocator). As Mr. Collin testified repeatedly, in order to achieve consistency in the allocation methodology, FG&E asserts it is logical to use the same allocation basis, that is gross plant. See, Exh. FGE-2 at 39. Because the FERC has already recognized the appropriateness of the gross plant method, the Department should adopt a gross plant allocator in this proceeding; the Attorney General has shown no other method to be more reasonable or appropriate.

D. Operating Expenses

1. FG&E's Proposed Bad Debt Adjustment is in Compliance with Department Precedent, Fully Supported by Record Evidence and Based upon Known and Measurable Changes

The Attorney General claims that, with regard to the 1999 Test Year bad debt adjustment, FG&E has not followed Department precedent and has not fully supported the data used in the associated three-year net write-off rate. AG Br. at 21.[3] On the contrary, as is explained below, FG&E did comply fully with Department precedent and supported all data utilized. Moreover, the Attorney General has had ample opportunity for further investigation on the record.

The Attorney General cites Department precedent for utilizing the most recent three year net write-offs to derive the net write-off rate to be utilized in the bad debt adjustment. AG Br. at 21. The Attorney General utilized the three year period 1998 through 2000 in developing the net write-off rate for his proposed Test Year 1999 bad debt adjustment. AG Br. at 21. FG&E used the three year period 1997 through 1999 in performing the Test Year 1999 bad debt adjustment. The Department recognizes that the "most recent three years' net write-offs" will not include net write-off data beyond the chosen test year. See Boston Gas Co., D.P.U. 96-50 (Phase I) at 70-71. FG&E complied with this as part of its Test Year 1999 bad debt calculation.

[3] The Attorney General has remained silent with regard to FG&E's 2000 Test Year bad debt adjustment.

In Boston Gas, the company filed on May 17, 1996 with a test year ending December 31, 1995. The Department utilized, for the most recent three year period, the net write-offs and firm revenue figures from 1993 through 1995 (the test year in Boston Gas' case) to determine the net write-off ratio to be utilized in Boston Gas' bad debt adjustment. Id., D.P.U. 96-50 (Phase I) at 71. The Attorney General actually supported that calculation for Boston Gas. Id., D.P.U. 96-50 (Phase I) at 66. It is the Attorney General, not FG&E, who is not conforming to Department precedent. The Attorney General should not be utilizing data that goes beyond the Test Year 1999 in calculating the uncollectible net write-off ratio.

Next, the Attorney General argues in brief that FG&E has provided incomplete information to support its net write-off ratios for the 1999 Test Year bad debt adjustment. AG Br. at 21.[4] This appears to be another attempt on the Attorney General's part to circumvent Department precedent and move the three-year calculation of the write-off ratio for Test Year 1999 forward to include the year 2000.

In point of fact, supporting information for the 1997 net write-off ratio appears on 1999 Sch. MHG Supp. 10. The Attorney General misapprehends that the record contains the breakdown of gross write-offs in 1997 by rate class, the total write-off recoveries for 1997, 1998, 1999, and 2000, *and* the 1997 net write -off ratio. Exh. AG-IR-1-69; Exh. FGE-2 (1999 Sch. MHC-Supp. 10). FG&E has presented ample detail on the 1997 ratio. The Attorney General's argument in this regard should be dismissed.

Finally, the Attorney General argues that the "revenue projections" used by the FG&E to pro form Test Year 1999 revenues for the bad debt adjustment are not known and measurable and an "obvious mismatch" that should not be allowed. AG Br. at 22. The adjustments made to

[4] Specifically, the Attorney General argues that there is no supporting information for the 1997 net write-off ratio on Exh. AG-IR-1-69. AG Br. at 21.

test year Standard Offer Service (SOS) and Default Service (DS), however, for the 2000-2001 SOS and DS price growth rates are known and measurable. FGE Br. at 23-24. The adjustments are conservative because they do not reflect increases that have taken effect since January 1, 2001. Id. The adjustments are consistent with Department precedent. Id.

With regard to the known and measurable nature of the SOS and DS adjustments, during cross examination the Attorney General asked Mr. Collin: if the adjustment included only those SOS and DS increases pre-January 2001, and Mr. Collin confirmed that it did. Tr. 2 (6/01/01) at 262. With regard to the precedent for the nature of the adjustment, FG&E codified its supporting data on this issue in its initial brief. FGE Br. at 24. It need not be repeated here.[5]

2. FG&E's Proposed Three Year Amortization Period for Rate Case Expense is Reasonable and Should be Allowed

The Attorney General accepted FG&E's rate case expense estimate of $400,000 and the only disagreement that remains is the attribution of a normalization period to be utilized for cost of service purposes. AG Br. at 23. The Attorney General describes his proposed normalization period of 5 years as conservative and in-line with Department precedent. AG Br. at 23.

In fact, the Department requires that a normalization period for rate case expense be derived based on the average of the intervals between the filing dates of a company's last four rate cases; this is intended to estimate the timing of the filing of the next case. In a Sec. 94 proceeding, such estimations are intended to guard against an overcollection. See AG Br. at 23. Here, there is absolutely no risk of overcollection of rate case expense: this is a Sec. 93

[5] FG&E would point out that in its view, the Attorney General inappropriately relies on D.P.U. 96-50 to argue that no other adjustments to test year revenues are proper except for weather adjustments. It is unclear from D.P.U. 96-50 whether the decrease in revenue was reflected by the Department in its calculation of the bad debt adjustment. In fact, Department precedent allows for the bad debt adjustment to reflect projected increases in revenue. Such an adjustment was proposed by Boston Gas. That is why FG&E included SOS and DS here, conservatively calculated.

proceeding. These costs are not setting recovery levels; they are demonstrating the justness of FG&E's current rate structure and levels. FG&E believes that a three year normalization period is more reasonable and appropriate, particularly for a Section 93 earnings review in which FG&E has no opportunity to raise rates.

As a practical matter, FG&E fully anticipates that a future rate proceeding for electric distribution operations related to the implementation of performance based ratemaking (PBR) will take place shortly, particularly in view of the recent issuance of the Department's order in D.T.E. 99-84 and the FG&E gas division's obligation to file a PBR within three months of the date of that order. Past history, particularly the 16-year stay-out period for the electric division, is much less representative of the timing of a future rate case for FG&E. FG&E's proposed three year normalization period is more representative and, to a large degree, quite conservative based on current expectations. It should be allowed.[6]

3. The Inclusion of the Test Year Level of Outside Services Expense in the Inflation Allowance is in Compliance with Department Precedent and Should be Allowed

The Attorney General is silent on the Test Year 2000 inflation adjustment proposed by FG&E. The major difference between the FG&E-proposed Test Year 1999 inflation adjustment and the proposal of the Attorney General is the exclusion of the Test Year 1999 level of outside service expense from the residual O&M amount used in the calculation. FGE Br. at 26-27; AG Br. at 23-24.

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[6] The Department should also note the following: based upon the rate case expense estimate of $400,000 and respective proposed normalization periods for FG&E of three years and for the Attorney General of five years, the resulting annual rate case expense to be attributed to FG&E's revenue requirement is $133,333 and $80,000, respectively. In Exh. AG-3, the Attorney General proposed an adjustment of $53,333 to reduce rate case normalization expenses; however, FG&E has identified an error on the Attorney General's summary of O&M adjustments. See, Exh. AG-3. He has adjusted his attribution of rate case normalization expense by $109,000. AG Br. at Attachment 1, Sch. 3. There is no evidence for an adjustment of $109,000.

The essence of the Attorney General's argument for excluding outside services from the inflation allowance is that the level of expense fluctuates from year to year. Tr. 1 (5/30/01) at 42. In addition, the Attorney General argues that it fluctuates in a manner that indicates the level of outside services expense does not increase with inflation. AG Br. at 24. The Attorney General further states that the level of outside services expense for the FG&E distribution function decreased by $400,000 in calendar year 2000 versus calendar year 1999[7] and therefore, no inflation adjustment should be allowed for this expense in the 1999 Test Year cost of service. AG Br. at 24.

The Attorney General has made another surgical strike here on Department ratemaking principles which, based on his own cited authority, dictate that expenses unadjusted elsewhere in the cost of service and affected by inflation will be bundled into a total dollar amount as residual O&M expense subject to the inflation adjustment. AG Br. at 23. The level of expense for some items in this "bundle" may increase at a rate that is greater than inflation and others, like outside services, may fluctuate from year to year due in large part to variations in business requirements. This method does not indicate that the level of expense in any one year is not subject to inflation particularly when, in the case of outside services, these expenses consist primarily of affiliated service company payroll and benefit costs and outside service charges. The major components of these charges are subject to inflation. FGE Br. at 27.

The Department's stated intent in granting an inflation allowance is that "the adjustment reflect the likely cost of *providing the same level of service in the future as was provided in the test year."* Boston Gas Co., D. P. U. 96-50 (Phase I) at 112 (emphasis added). The variation of the level of outside services expense from year-to-year based upon business requirements of

[7] An occurrence that did not deter FG&E from advocating a preferred 2000 test year that recognizes the most recent information available for cost of service purposes.

FG&E is therefore not a reason for excluding the test year level of these expenses from the inflation adjustment as the Attorney General proposes. Finally, to FG&E's knowledge, there is no precedent for eliminating outside service expense from the residual O&M expense subject to the inflation allowance. FG&E's inflation adjustment should be utilized, just as the Department has allowed such calculations in the past. Boston Gas Co., D.P.U. 96-50 (Phase I), Table 1, at 113A; Fitchburg Gas and Elec.Light Co., D.T.E. 98-51, Table 1, at 103.

4. The Reclassification of 1998 Expenses were not Included in the Test Year 1999 Operation and Maintenance Expense and the Attorney General's Exclusion of these Expenses from the Test Year 1999 Cost of Service Should be Denied

During the Test Year 1999, FG&E reclassified $74,000 of 1998 Independent System Operator expenses and $127,000 of 1998 System Control and Load Dispatch expenses from transmission expense to distribution expense. Exh. AG-3; Exh. AG-IR-5-5. The Attorney General continues to propose elimination of these expenses from the 1999 Test Year cost of service arguing that FG&E has not demonstrated that these expenses were not included in the Test Year 1999 distribution operation and maintenance expense. AG Br. at 25.

Quite specifically, FG&E in fact made this demonstration. Exh. AG-1R-2-8, Attachment AG-2-8-2, details the Test Year 1999 per books operation and maintenance expense utilized by FG&E in its proposed test year cost of service. Exh. FGE-2 at 1999 Sch. MHC Supp-2. The distribution-related accounts on Exh. AG-1R-2-8, Attachment AG-2-8-2, cover Accounts 580 through 596 and Account 598. None of the accounts other than Account 581 - "Load Dispatch" and Account 588 - "Misc. Distribution Expense" can be viewed as appropriate accounts for reclassification of the 1998 expenses in question based upon the account definitions on Exh. AG-IR-2-8, Attachment AG-2-8-2. Further, Account 581 shows a zero balance on the schedule for

1999. Account 588 shows a balance of $69,349. Both are less than the expense levels in question. More importantly, Mr. Collin testified under oath that he had confirmed that these expenses were not booked to any of the accounts shown on Exh. AG-IR-2-8, Attachment AG-2-8-2. See Tr. 2 (6/1/01) at 284. This testimony is uncontradicted.

The sworn, in-hearing testimony of Mr. Collin, as well as a reasonable review of the nature and magnitude of the 1999 expenses appearing on Exh. AG-IR-2-8, Attachment AG-2-8-2, when compared to the reclassified amounts in question, is sufficient to demonstrate that the expenses have not been included in the Test Year 1999 operation and maintenance expense. The Attorney General's proposal to eliminate these expenses from the 1999 Test Year cost of service should be disallowed.

5. The Record Supports FG&E's Proposed Depreciation Expense Adjustment for Purposes of this Proceeding

The Attorney General argues that "the record evidence does not support FG&E's depreciation expense adjustment." AG Br. at 25. The Attorney General, for the first time on brief, has dramatically reversed and undercut his own expert witness who adopted the higher depreciation rates proposed by FG&E and derived from the 1998 study. Exh. AG-2 at 6; Exh. AG-3 (Mr. Effron accepted FG&E's depreciation rates in revised COS); Tr. 1 (5/30/01) at 6. The Attorney General asserts he had no ability to conduct discovery and cross examination of an expert witness regarding the "account-by-account detail of the depreciation study." AG Br. at 25-26. In FG&E's view this accusation is empty and preposterous. Mr. Effron accepted the results of the depreciation study conducted in 1998. Exh. AG-3; Tr. 1 (5/30/01) at 8-9. Furthermore, the Attorney General had ample opportunity to file information requests, to cross-examine FG&E's witnesses, and to request an expert witness to present testimony on the

depreciation study. He did not do so, and moreover, his own expert indicated this was unnecessary. The Attorney General's arguments here are without merit and should be dismissed.

Furthermore, the Attorney General has not properly calculated his newly proposed pro forma depreciation expense. The amount proposed is $1,579,000. AG Br. at Att. 1, Sch. 3, ($1,396,000+$111,000+$72,000). The first and last items here reflect the Attorney General's purported actual Test Year 1999 depreciation expense of $1,468,000 for distribution and common plant, respectively, based on the FG&E's 1999 FERC Form 1. The second item ($111,000) is an adjustment to his actual test year expense to reflect end-of-year plant. However, FG&E submitted detail supporting the actual Test Year 1999 depreciation expense for the distribution operations in the amount of $1,669,206. Exh. AG-IR-4-13 at Att. AG-4-13. The correct amount of test year depreciation expense, absent any change from current depreciation rates (as is proposed by the Attorney General), is correctly $1,780,206 ($1,669,206+$111,000). Properly displayed, the Attorney General's new position reflects an increase of $201,000 to his depreciation expense and his resulting revenue requirement.

The Attorney General also asserts on brief that he established in cross-examination that there are problems with FG&E's proposed depreciation accrual rates that would cause annual depreciation expense to be greater than the current underlying net book value of the plant. AG Br. at 26. However, the Attorney General has mischaracterized the concept of depreciation expense. As Mr. Collin explained, the depreciation expense consists of recovering not only the original cost of plant but also the cost of removal of the plant, net of salvage. Tr. 2 (6/01/01) at 282. As the title implies, cost of removal net of salvage (if any) occurs at the end of the useful life of the plant. The removal cost, net of salvage, is a real cost incurred by FG&E, in addition to the original book cost incurred at the beginning of the plant's service life; it must be recovered in

rates during the period of service to customers. Therefore, the removal cost net of salvage, is made a component of depreciation accrual rates and the resulting annual depreciation expense determined within a periodic depreciation study.

Contrary to the Attorney General's assertion that the plant account is depreciated down to a negative value, the plant account remains at the amount of the original cost during the plant's service life. The depreciation reserve account accumulates the annual expense amounts, which consist of both the original book cost and the anticipated cost of removal, net of salvage. If the net of the two accounts ever becomes negative, it is in anticipation of the additional cost of removal when retiring the plant at the end of its service life.

FG&E's position is unchanged regarding the proper level of depreciation expense for Test Year 1999 to be reflected in the analysis in this proceeding. FG&E has presented ample support and documentation for its proposed expense reflecting higher depreciation rates from a study performed by a depreciation expert. FG&E has revised the original rates to reflect the impact of certain changes made by the Department in D.T.E. 98-51 to FG&E's gas property depreciation rates from the same study. The proposed depreciation for the Test Year 1999 is $2,290,909. Exh. FG&E-2 (Sch MHC Supp-16).[8]

6. The Attorney General Misstates the Impact of Related Issues from Docket 99-110 on the Revenue Requirement Calculation in this Case

The Attorney General has misrepresented FG&E's position, as well as ignored the sworn testimony of Mr. Collin in this proceeding, relating to the issues in D.T.E. 99-110. The Attorney General alleges that the Department's ruling in D.T.E. 99-110 will not affect the distribution rates under review in the current proceeding. AG Br. at 27. In fact, a ruling against FG&E's position

[8] FG&E's proposed depreciation and amortization expense for Test Year 1999 is $2,343,969 , Exh FG&E-2, Sch MHC Supp-1 including test year amortization expense of $53,060, on which FG&E and the Attorney General are in agreement.

could significantly impact FG&E's distribution rates. For example, FAS 109 deferred taxes must be recovered from customers. D.T.E. 99-110 will determine whether they should be recovered as a generation-related item or as a distribution item. Tr. 2 (6/01/01) at 233.

If the issues in D.T.E. 99-110 are decided in favor of FG&E's proposals in that docket, and allowed to be recovered through the Transition Charge and related adjustment mechanisms, there is no need to adjust rates to acknowledge these costs in the current proceeding. However, if the Department decides that these issues are not generation/divestiture-related, and that they more appropriately relate to the distribution function, then FG&E must be permitted, and should not be precluded from, the ability to justify their inclusion in the cost of service, as a distribution expense. See, Tr. 2 (6/01/01) at 234. These costs are 1) FAS 109 regulatory asset, 2) the $2.1 million transaction and administrative costs associated with divestiture and 3) the $1.8 million of power supply management and administrative costs.

Regarding the FAS 109 regulatory asset, the Attorney General believes there would be no revenue requirement impact if his position in D.T.E. 99-110 were to be accepted by the Department. AG Br. at 27. The Attorney General comes to this conclusion based upon the interpretation that the generation-related FAS 109 asset has already been included by FG&E in the accumulated deferred income tax component of rate base in this proceeding. AG Br. at 27-28. This interpretation also stems from the absence of a specific, identified assignment of the regulatory asset to generation within the calculation of accumulated deferred income taxes. See AG Br. at 28. However, this interpretation is totally incorrect. The record indicates that the FAS 109 regulatory asset related to the generation function was not included in the calculation of the amount of accumulated deferred income taxes assigned to the distribution function in this proceeding. Tr.1 (5/30/01) at 106; Exh. AG-IR-7-5; Exh. AG-RR-1-1; Exh. AG-IR-4-7.

Therefore the generation-related FAS 109 regulatory asset does not "have to be eliminated by means of assignment to the generation function." Exh. AG-IR-7-5. It was not included in the balance to begin with.

FG&E's position is that the generation-related FAS 109 regulatory asset and the related deferred taxes should continue to be collected through the Transition Charge. FGE Br. at 37. The other two costs (divestiture-related transaction costs and power supply management costs) are similar in nature, in that they were extraordinary in amount and incurred over the time period 1997-1999 as part of the electric restructuring plan filed by FG&E. Since these latter costs arose from FG&E's restructuring efforts and since the electric restructuring benefitted customers, such costs should be recovered from customers in the established restructuring-related rate mechanisms. Furthermore, in D.T.E. 99-110, FG&E proposed reasonable amortization periods for cost recovery in the Transition Charge. If the Department disallows such recovery as not otherwise transition cost-related, then FG&E should not be precluded but rather should be permitted the opportunity to justify their inclusion in its cost of service as a distribution expense.

IV. COST OF EQUITY

A. The Attorney General Provides No Expert Testimony to Establish a Prima Facie Case Nor to Rebut Dr. Hadaway

As a preliminary matter, it is important to note that the Attorney General did not sponsor an expert witness on cost of capital to either establish his prima facie case or rebut FG&E's expert testimony. The Attorney General's only witness, Mr. Effron, readily concedes that he is not a cost of capital expert. Exhibit AG-1 at 8. Moreover, though Mr. Effron proffered an estimate of an appropriate return on equity; which the Attorney General used to support his prima facie case, the Attorney General now abandons the opinion of his own witness, confirming Mr. Effron's lack of credibility on this subject. Compare Exh. AG-1 at 8 with AG Br. at 40-41. The Attorney General now attempts, post-hearing, to propose a cost of equity based upon

"testimony" of counsel which is not supported by any credible record evidence, nor was subject to the scrutiny of cross examination.[9]

For all of the reasons recited in its pending Motion to Dismiss, the Company again requests that the Department reject the Attorney General's claims because of his failure to establish a prima facie case supported by expert testimony. See FG&E Motion to Dismiss at 7. By his own reckoning, the Attorney General claims that his burden in this matter is to set forth a prima facie case of FG&E's "overearnings," i.e. earnings in excess of an appropriate return on FG&E's investment. See AG Br. at 5. The only component of that return with which the Attorney General disagrees with FG&E on the appropriate return on equity. See AG Br. at 30, note 15.

While the Attorney General's mere rebuttal of the Company's cost of equity witness may be appropriate in a Sec. 94 proceeding, where a utility has the burden of proving new rates, his failure to sponsor an expert witness on cost of equity is a fatal flaw in this Sec. 93 action. The core allegation of the Attorney General's complaint in this case is that FG&E's electric division is "over earning," yet he provides no credible evidence, nor a supporting expert, to establish a prima facie demonstration of what constitutes a reasonable return on equity in order to prove his over earnings claim. The Supreme Judicial Court has considered, and expressly rejected, establishment of cost of equity for a utility by merely challenging the testimony of the opposing parties expert witness.

[9] The primary evidentiary support for the Attorney General's new position on brief are several responses to record requests issued to Dr. Hadaway the last day of hearings. The record requests were allowed, over FG&E's objection, even though Dr. Hadaway testified that the requested analysis would be inaccurate and would not reflect a valid estimate of FG&E's cost of equity. Tr. 2 (6/1/01) at 190-193. Accordingly, the Department should afford little or no evidentiary weight to the Attorney General's use of these responses to support his new cost of equity proposal.

> It may be conceded that the department is not bound by the testimony of the companies' expert, but non acceptance of testimony does not create substantial evidence to the contrary.

Salisbury Water Supply Co. v. Dep't of Pub. Utils., 344 Mass 721, 184 N.E.2d 47-48 (1963).

Even the Department's own expertise and skill does not provide sufficient power to create such evidence where none exists. Id. Accordingly, the Department should, at the very least, give no evidentiary weight to the Attorney General's post-hearing cost of equity proposal and may decide to dismiss the Attorney General's claims for failure to establish a prima facie case.

B. Dr. Hadaway Appropriately Assesses The Investment Risk In The Electric Industry

As noted by Dr. Hadaway in his prefiled testimony, a reasonable return on equity for a utility is directly tied to what equity investors are willing to pay for that security. Exh. FGE-4 at 21. When "risk perceptions" increase or financial prospects decline, investors reduce the price they are willing to pay, thus decreasing the market price of those securities and increasing a company's cost of capital. Id. In this context, Dr. Hadaway addressed in his testimony recent investor trends and perceptions, including the "flight to safety" following the Asian financial crisis in 1998 and the precipitous drop in utility stock prices following the California energy crisis. Exh. FGE-4 at 19-22.

The Attorney General's claim that Dr. Hadaway "over states" FG&E's cost of equity by referencing the California energy crisis and the risk of restructuring is inaccurate. See AG Br. at 30-31. First, Dr. Hadaway noted these developments in the context of investor perceptions and trends, and offered no specific adjustment to his recommended return on equity for FG&E to account for these perceptions. Second, the Attorney General's bare claim that the risks faced by the utilities in California are inapplicable to FG&E is based on a false premise that the California utilities are "vertically integrated electric utilities," rather than distribution companies. AG Br. at

30-31. In fact, the electric utilities facing bankruptcy in California are not vertically integrated companies, but are, just like FG&E, distribution subsidiaries in holding company systems which have restructured and divested their generation assets. PG&E National Energy Group, FERC Docket No. EC01-49-000 (January 12, 2001).

Finally, the Attorney General's own positions in the Company's ongoing restructuring reconciliation proceedings demonstrate that FG&E continues to face the risk of cost disallowance as a result of electric industry restructuring. In DTE 99-110, the Attorney General seeks to deny FG&E recovery of millions of dollars of costs through the transition change, while at the same time making no adjustment for these extraordinary costs in estimating the Company's base rates in this proceeding. While the Company is confident that the Department would not impose such a confiscatory rate reduction on FG&E, the very fact that the Attorney General continues to argue for the disallowance of significant costs resulting from restructuring only confirms the validity of Dr. Hadaway's observation that investors perceive greater risk in today's restructured electric markets[10]

C. Dr. Hadaway's DCF Analysis Employs An Appropriate Comparison Group To Provide A Conservative Estimate Of FG&E's Cost Of Equity

In selecting a comparison group of electric utilities for his DCF analysis, Dr. Hadaway purposefully included utilities with a lower risk profile than FG&E in order to produce a conservative estimate of the Company's cost of equity. Exh. FGE-4 at 23; Exh. AG-IR-6-10; Tr. 2 (6/1/01) at 171-172. Dr. Hadaway generally selected utilities for the comparison group which 1) were much larger than FG&E; 2) had a higher equity component in their capital structure than

[10] FG&E notes that the Department has taken significant steps, such as providing for the pass through of recent fuel increases in standard offer rates, to avoid many of the pitfalls which created the energy crisis in California. See D.T.E. 00-66, 00-67, 00-70 (2001). Nevertheless, FG&E continues to be the provider of last resort in an extremely volatile electric market.

FG&E; and 3) had a higher bond rating (single A or higher) than FG&E's implied bond rating of triple B. Tr. 2 (6/1/01) at 171-172. He also excluded those companies with less than a total of 75% electric revenues. Exh. FGE-4 at 23; Exh. AG-IR-6-10. Thus, the comparison group reflects utilities with a lower, rather than greater, risk profile than FG&E, contrary to the assertion by the Attorney General.

Additionally, the Attorney General's reliance upon the Department's findings in D.P.U. 95-40 are misplaced. Compare AG Br. at 31 with Massachusetts Elec. Co., D.P.U. 95-40, at 95-96 (1995). Contrary to the Attorney General's characterization, the Department did not make a broad finding in that case that restructured electric distribution companies face less risk than utilities with generation and non utility subsidiaries. AG Br. at 31. Rather, the Department found that, for the specific comparison group employed in that case, "the comparability of both the risk and growth factors is questionable based on such factors as the ownership of non-utility subsidiaries, generation responsibility and a non-diversified fuel mix."[11] D.P.U. 95-40 at 96. While the Department found that the record evidence in that case showed that the comparison group includes companies with more business risk than Massachusetts Electric Company, the record evidence in this case shows that Dr. Hadaway deliberately chose a comparison group with less business risk than FG&E.[12]

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[11] It is important to note that in Massachusetts Elec. Co., D.P.U. 95-40 (1995), the Department was not considering a vertically integrated utility which was, or had been, recently restructured. MECo had been a standalone distribution company for many years and the dispute over determining an appropriate "comparable group" for establishing its cost of equity was long-standing. See Massachusetts Elec. Co. v. Dep't of Pub. Utils., 376 Mass. 294, 300 (1978).

[12] The recent financial crisis faced by the electric distribution utilities in California, and record earnings by many generators in that same market, also contradict the Attorney General's claim that distribution companies undergoing restructuring are inherently less risky.

D. The Record Evidence Supports Dr. Hadaway's Constant Growth Analysis

There is no credible record evidence to support the Attorney General's assertion on brief that the 6.36% growth rate used in Dr. Hadaway's constant growth analysis was too high. See AG Br. at 33. Dr. Hadaway calculated this growth rate by taking the average of three different proxies: Zack's five year earning per share growth rate; Value Line Investment Survey's three to five year earnings per share growth rate; and a calculation of growth from retained earnings based on Value Line data. Exh. AG-IR-6-15. Consistent with Department precedent, Dr. Hadaway used a variety of quantitative factors to estimate investor expected growth. See Fitchburg Gas and Elec. Light Co., D.T.E. 98-51, p.120 (1998).

The Attorney General offers no record evidence, or any explanation, of why the Gross Domestic Product ("GDP") is appropriate as a proxy for an investor expected growth rate of a utility stock. AG Br. at 33. Nor does the Attorney General explain why the ten year average for the last decade is appropriate, particularly given that it is in fact a short term growth calculation (1991-2000), based upon a period of very low inflation rates. If the Department were to compare the GDP growth rates for longer period, based upon the same source as provided by Dr. Hadaway, it would find that for any period but that chosen by the Attorney General the GDP rate is similar to, or higher than, that employed by Dr. Hadaway.[13]

Similarly, the Attorney General asserts an average ten-year historical growth rate of 1.1% to 1.7%, without supporting testimony or any explanation of how he derived this average. Id. Moreover, he generally cites the Value Line data (Exh. AG-1R 6-13; Exh. AG-1R 6-14) for the

[13] Compare Exh. AG-RR-5 with US Commerce Department, (www.commerce.gov) Bureau of Economic Analysis, GDP and Related Data, Current Dollar and Real GDP (2001).(Annual % change in Normal GDP: 1981-2000-6.58%; 1971-2000-7.86%; 1961-2000 7.65%)

comparison group of companies, many of which have experienced restructuring, divestiture and related write-offs during the past 10 years, producing a downward bias in any growth trends.

E. The Attorney General's Proposed Use Of Forecasted Price To Earnings Ratio In The Terminal Value DCF Analysis Does Not Accurately Reflect The Company's Current Cost Of Equity`

The record evidence demonstrates that the Attorney General's proposed use of a modified Terminal Value DCF analysis is inaccurate and not a valid estimate of FG&E's current cost of equity. Compare Tr. 2 (6/1/01/) at pp. 190-191 (use of Value Line projected price/earnings ration to determine Terminal Value in RR-AG-4 is not an accurate estimate of the cost of equity) with AG Br. at 34 (citing to Exh. AG-RR-4). Without support expert testimony, the Attorney General once again asks the Department to adopt analysis described as inaccurate by the one expert witness in this proceeding. TR.2 (6/1/01) pp. 190-191. The Attorney General's proposed analysis produces a skewed result by ignoring current P/E ratios to determine investor's current expectations. Tr.2 (6/1/01) at 189.

The DCF "terminal price" non-constant growth model estimates what investors would expect to earn it they bought a stock at today's market price, held it for the transition period and then sold it. Exh. FGE-4, p.14. It is intended to estimate the rate of return that investors expect to receive given the current level of market prices they are willing to pay. Id. Accordingly, in his analysis, Dr. Hadaway calculates the terminal value of company's stock by starting with today's current market prices and P/E ratios, and applying them forward to determine what investors expectations are. Id.

The Attorney General's proposed used of the Value Line P/E forecast only is misplaced because it does not reflect then current investors requirements to determine what the Company's cost of equity should be today. Id. at 191. Instead, it reflects an estimate into the future, perhaps suggesting a future return, but producing an inaccurate estimate of FG&E's current cost of

equity. Id. at 190-191. The Attorney General's proposed methodology, unsupported by expert testimony, is in fact internally inconsistent and repudiated by Dr. Hadaway. Accordingly, the Attorney General's proposed return on equity based on the skewered analysis should be rejected.

F. There Is No Record Support For The Attorney General's Proposed Use Of A 5.57% Normal Growth Rate In The Non Constant Growth Rate DCF

In proposing the Department accept a cost of equity estimate of 10.8% under a revised Non-Constant Growth Rate DCF analysis, the Attorney General again bases his request upon a repudiated exhibit without expert support. See AG Br. at 36 (citing Exh. RR-AG-AG-5). Though Dr. Hadaway did not weigh this model heavily in his analysis, the Attorney General provides no evidentiary support or rationale for use of his 5.57% growth rate. See, infra, Section 4, p.26. On brief, counsel 'testifies' that the 5.57% growth in the Gross National Product is an appropriate growth rate for use in this model, but the only record evidence clearly repudiates his claim. See Exh. AG-RR-5 (noting that the analysis is not a valid estimate of FG&E's cost of equity). Dr. Hadaway has provided a reasoned analysis for his use of a blended short term and long term data to derive an estimated growth rate, which should be recognized by the Department.

G. The Record Does Not Support Adoption Of The Attorney General's Risk Premium Analysis

Dr. Hadaway's return on equity recommendation is based principally upon his DCF analysis, which is typically endorsed most strongly by regulatory commissions. Tr. 2 (6/1/01) at 154-155. In his testimony he also provided a risk premium analysis, fully recognizing that it is only used as a secondary source or check of reasonableness in many regulatory jurisdictions. See Exh. FGE-4 at 11. The risk premium analysis, which Dr. Hadaway admits requires more extensive data and underlying assumptions, has been offered as a parallel approach to the DCF

model, to ensure consistency with other capital market data in the cost of equity estimation process. Id.

In his rebuttal of Dr. Hadaway's risk premium analysis, the Attorney General offers the same critiques raised in FG&E's last gas base rate case, DTE 98-51, and an alternative proposal that is wholly lacking in record support. See AG Br., at 37-39. As the Attorney General provides no explanation, calculation or derivation for counsel's revised risk premium rates, FG&E offers no detailed reply to this extra-record rebuttal. The Attorney General critique of Dr. Hadaway's analysis can not create substantive evidence to the contrary. Salisbury Water Supply Co. v. Dep't of Pub. Utils., 344 Mass at 716, 184 N.E.2d at 46.

In regard to the Attorney General's specific critique of Dr. Hadaway's use of Moody's Bond Yields, there is no record evidence suggesting these are not representative of electric distribution utilities. AG Br. at 37. Similarly, the Attorney General missed the mark in characterizing Dr. Hadaway's use of return on equity authorized by public utility commissions as meaningless. AG Br. at 38. The rates of return authorized by other commissions reflect what other comparable companies have an opportunity to earn, and thus are reflective of the market and provide a valid indicator of what is a just and reasonable return. See Federal Power Commission v. Hope Natural Gas Co., 320U.S. 591 (1944); Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia; 262 U.S. 679 (1923).

H. Dr. Hadaway's Recommended Return On Equity Is Consistent With The Department's Determination In DTE 98-51 And Within A Zone Of Reasonableness

In 1998, the Department authorized an 11% return on equity for FG&E's gas division, following its review of Dr. Hadaway's cost of equity analysis in which he recommended a return on common equity of 11.25%. DTE. 98-51 at p. 127. In the intervening two and one half years, interest rates have increased by approximately 100 basis points while electric utilities have faced the risks of restructuring, volatile markets and the evolving energy crisis. Tr. 2 (5/30/01) at 226-27. Given the corresponding increase in interest rates, which continue to grow, Dr. Hadaways recommended range of return on equity (10.5% to 12/5%) is entirely consistent with the 11% authorized by the Department in 1998. Tr. 2 (5/30/01) at 156, 226-27.

While the Attorney General does not comment specifically on FG&E's proposal for the Department to Utilize a range of reasonable returns in its Section 93 review, he appears to endorse the concept. AG Br. at 40-41. In his testimony on brief, the Attorney General suggests "a range of reasonable returns." Id., at 44. Accordingly, the Department should employ a range of returns in evaluating the Attorney General's claims, based upon the range of 10.5% to 12.5% as supported by the expert testimony of Dr. Hadaway.

V. CONCLUSION

WHEREFORE, for all the reasons set forth in its initial brief and on this reply, Fitchburg Gas and Electric Light Company respectfully requests that the Department of Telecommunications and Energy find that the Attorney General has failed to demonstrate that

FG&E's rates are unjust and unreasonable, that it deny and dismiss the Attorney General's 1998 Complaint, and that it provide such other relief as it may deem just and reasonable.

Respectfully submitted,

FITCHBURG GAS AND ELECTRIC
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